BUSINESS LAW SECTION

THE STATE BAR OF CALIFORNIA

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November 8, 2007

VIA E-MAIL: regulations@corp.ca.gov

Ms. Karen Fong
Office of Legislation and Policy
Department of Corporations
1515 K Street, Suite 200
Sacramento, California 95814-4052

Re: California Department of Corporations File No. PRO 27/03 – Investment Adviser Omnibus Rulemaking: Custody, Advertising, Cash Solicitation, Soft Dollars, Unethical Practices, Conflicts of Interest, and Books

Dear Ms. Fong:

We are writing to comment on the above-referenced proposal (the "Proposed Rules") issued by the California Commissioner of Corporations (the "Commissioner") on August 8, 2007, to amend, repeal and adopt various sections of the California Code of Regulations that relate to investment advisers.

These comments are provided on behalf of the Corporations Committee (the "Committee") of the Business Law Section of the State Bar of California (the "Business Law Section"), with authorization from its Executive Committee. The Committee is composed of attorneys with extensive experience advising California corporations and out-of-state corporations transacting business in California on, among other things, the California Securities Law and the rules of the Commissioner adopted thereunder.[1]

Summary

A. While we support and agree with the Commissioner's express goal of increasing uniformity among state and federal regulations, today we are writing to

[1] Some members of the Committee practice in private law firms that regularly represent investment advisers doing business in California. Those Committee members were among the members principally responsible for preparing this letter. In addition to availing themselves of the information and resources of their private law firms, the Committee consulted with experienced members of the investment management bar, who are also members of the Business Law Section but not members of the Committee.

recommend to the Commissioner that the Proposed Rules (other than the proposed custody rules, subject to certain modifications) not be adopted as drafted for reasons summarized as follows:

1. State-regulated investment advisers often differ significantly from their federally-regulated counterparts. We believe that the Commissioner should not subject state-regulated investment advisers to a broad-brush approach to compliance that tracks the federal standards. Rather, we believe that each rule should be considered on its own merits and be based on empirical evidence that increased regulation on the federal model will benefit clients of California advisers.

2. By incorporating standards published by the SEC (or in some cases by SEC Staff) in interpretive letters and releases, no-action letters, and speeches by SEC officials, the Proposed Rules create new disparities between state and federal regulation and the possibility for greater disparities in the future.

3. By restating federal statutes and rules verbatim, the Proposed Rules risk creating additional disparities with the federal regulatory system. We recommend that, where conformity with federal or model rules is appropriate, rulemaking in this area explicitly cite directly or incorporate by reference the federal or model rule and any successor provision thereto.

B. If the Commissioner does not accept our recommendation summarized in A above, we would then recommend that the period for the submission of written comments be extended by ninety days to January 28, 2008. Given the complexity of the Proposed Rules and the concurrent development of standards and practices on the federal level (and within the investment management industry generally), the comment period should be extended to allow the members of the bar and members of the investment community to better understand and assess the legal and practical issues raised by the Proposed Rules.

C. If the Commissioner does not accept our recommendation summarized in A above and also does not accept our recommendation summarized in B above, we would then recommend that the Proposed Rules be made effective no earlier than January 1, 2009 or at least one year from the date of adoption (whichever is later). We believe the additional time is necessary and appropriate in light of the significance of the burden imposed by the Proposed Rules.

D. We recommend the adoption of Proposed Section 260.237, subject to certain modifications.

E. We recommend amendment of several of the Proposed Rules for which the scope appears to exceed the statutory authority of the Commissioner.

F. Finally, we call attention to what appear to be typographical or similar clerical errors in the text of the Proposed Rule.

Commentary

A. We recommend that the Proposed Rules not be adopted for the following reasons:

1. State-regulated investment advisers often differ significantly from their federally regulated counterparts. We believe that the Commissioner should not subject state-regulated investment advisers to a broad-brush approach to compliance that tracks the federal standards. Rather, we believe that each rule should be considered on its own merits and be based on empirical evidence that increased regulation on the federal model will benefit clients of California advisers.

The general effect of the Proposed Rules is to conform California investment adviser regulation to federal law. By way of introduction, the Proposed Rules would substantially amend the current compliance requirements applicable to state-regulated investment advisers. The Commissioner's Initial Statement of Reasons for the Amendments (the "Statement of Reasons") cites two general objectives sought to be achieved by these amendments: (1) increased consistency with federal law and the Model Rules (the "Model Rules") of the North American Securities Administrators Association (the "NASAA"), and (2) enhancing investor protections.[2]

Generally speaking, the Committee is concerned about the wholesale approach of imposing federal regulatory requirements on California investment advisers. Federal law has evolved with a focus on investment advisers that are by definition larger and consequently have greater resources and often operate with business models that may be quite different than those of many state-regulated investment advisers. When Congress adopted the National Securities Markets Improvement Act of 1996 ("NSMIA"),[3] it authorized the SEC to regulate investment advisers with greater than $25 million in assets under management because the activities of those investment advisers activities were more likely to impact the national securities markets.[4] In general, state regulation was reserved under NSMIA for investment advisers with fewer assets under management.[5]

Following the passage of NSMIA and its distinction of investment advisers by amount of assets under management, the SEC modified and expanded the federal requirements applicable to federally registered advisers.[6] These federal rules require larger advisers to develop and

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[2] *See generally* Document 27/03 C.

[3] 104 P.L. 290.

[4] *See* 15 U.S.C. § 80b-3a.

[5] We recognize that the statutory technique Congress used to accomplish that division allows states to require registration and regulation of larger investment advisers that are exempt from SEC registration under Section 203(b)(3) of the Advisers Act and that the Commissioner has proposed a change in Section 260.204.9 related to that fact. Nonetheless, NSMIA's general principle of dividing regulatory jurisdiction remains as stated.

[6] *See, e.g.,* 17 C.F.R. 275.204A-1 (requiring the adoption of a code of ethics by federally registered investment advisers).

maintain systems of control and compliance, to regularly and continuously record and disclose compliance with laws, and to adhere to and reassess internal compliance systems. They were crafted for the investment management organizations that, consistent with their larger businesses, generally have more sophisticated infrastructure than many state-regulated investment advisers and that may be better able to bear costs of implementation.

The investment advisers that would be subject to the Proposed Rules are generally smaller than SEC-registered advisers and often operate with considerably fewer employees and resources. We note the determination, contained in the Commissioner's notice of the Proposed Rules, that the Proposed Rules do not affect small businesses.[7] However, despite being technically excluded from the definition of "small business" by virtue of Government Code § 11342.610(b)(1), many California-licensed investment advisers are in fact small businesses in the ordinary sense of the term.

The Committee does not have access to comprehensive data about California-licensed advisers that would allow it to assess whether federal-type regulations are appropriate or necessary for this group. But, we are concerned that the Proposed Rules do not adequately take the nature of these advisers into account. We do know that many California-licensed advisers are financial planners with little or no discretion over their clients' accounts or custody of their assets, or are advisers that give advice only about mutual funds and similar pooled investment products. Also, some California-licensed advisers do no more than publish subscription-based newsletters. In this connection, we note that Section 11346.2 of the Government Code requires an agency's initial statement of reasons for rulemaking to state "the rationale for the determination by the agency that each . . . amendment . . . is reasonably necessary to carry out the purpose for which it is proposed."[8] Many small advisers in California do not necessarily pose the same risks *vis-à-vis* the investing public as those seen among most of the advisers subject to the federal regulations.

By way of example, smaller advisers may not present the significant concerns about conflicts of interest and insider trading that motivated the SEC to adopt a code of ethics requirement. Similarly, in many instances, the business continuity plan requirements of Proposed Section 260.238.4 may not be a necessary or realistic approach to protecting clients of all advisers subject to the Proposed Rules.[9]

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[7] *See* Document 27/03 A at 6.

[8] CAL. GOV. CODE § 11346.2.

[9] Another example, as a technical matter, appears in Proposed Section 260.238.1, requiring "access persons" to report shares issued by "reportable funds" (i.e., federally registered investment companies managed by the California–licensed adviser or by a company that controls the California-licensed adviser). But, under Sections 203(a), 203(b)(3), and 203A(a)(1)(B) of the Investment Advisers Act of 1940, advisers to a federally registered investment company must also register with the SEC and therefore would be excluded from the ambit of California regulation and the Proposed Rules generally. Along the same lines, Proposed Section 260.238.2 regulates "soft dollar" practices when it is clear that such regulation is already addressed by federal statute and is uncertain that a state could regulate in this area without specific legislative direction. *See* text at note 25 *infra*.

The Proposed Rules would doubtless require California-registered investment advisers to incur significant additional cost and expend valuable time and money on the adoption and implementation of federal-type regulations and the training of personnel or employment of new staff. We note that the Statement of Reasons frequently refers to improved investor protection, among other justifications,[10] but does so in a conclusory manner, without reference to empirical or factual information to support these conclusions and without reference to consideration of the types of investment advisers the Proposed Rules (as opposed to corollary SEC Rules) would affect. In this connection, we call your attention to Section 11346.5 of the Government Code, which requires a notice of proposed regulatory action to include a "description of all cost impacts, known to the agency at the time the notice of proposed action is submitted to the office, that a representative private person or business would necessarily incur in reasonable compliance with the proposed action."[11]

While the costs of compliance under the Proposed Rules may be unknown, we know the costs of implementing and adhering to certain federal requirements have not been without controversy. Following the 2003 and 2004 adoption of federal compliance rules, empirical studies have consistently demonstrated substantially increased compliance costs incurred by SEC-registered advisers. Those studies also found significant expenditures of time and other resources by advisers that would otherwise be devoted to client interests.[12] Likewise, the federal compliance rules required advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures. At the time, the Investment Counsel Association of America (subsequently renamed "Investment Adviser Association") (the "ICAA") estimated that, depending on an adviser's size and complexity, it could purchase an off-the-shelf compliance manual for under $1,000, but

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[10] The Statement of Reasons also justifies the Proposed Rules as promoting ethical behavior, preventing transactions conflicts of interest, reducing insider trading and the like. *See generally* Document 27/03 C.

[11] CAL. GOV. CODE § 11346.5. *See also* CAL. GOV. CODE § 11346.2 (requiring the initial statement of reasons in support of proposed regulatory action to include "[f]acts, evidence, documents, testimony, or other evidence on which the agency relies to support an initial determination that the action will not have a ***significant adverse economic impact on business***") (*emphasis added*).

[12] *See* Stephen L. Carlson and Frank A. Fernandez, THE COSTS OF COMPLIANCE IN THE U.S. SECURITIES INDUSTRY, SIA Research Reports (Feb. 22, 2006) (available at http://www.sifma.org/research/surveys/pdf/CostofComplianceSurveyReport.pdf). That report found, based on a survey, that a majority of smaller SEC-registered investment advisers had experienced "major" increases in total compliance costs over the previous five years. The most obvious cost increases were attributable to growth in staff-related spending. But one respondent remarked that "[a]side from the hard monetary costs, there is also the cost of lost performance due to the attention diverted away from executing the core business. This cost is not quantifiable." Similarly, a November 2005 survey of members of the Investment Advisers Association **[NB: Investment Adviser Association defined subsequent to footnote 12. *See* text at note 13 *infra*.]** found that costs associated with compliance under the SEC's (now-vacated) hedge fund manager registration rule, 17 C.F.R. 275.203, *et seq.*, *vacated by Goldstein v. SEC*, 371 F.3d 358 (D.C. Cir., 2006), averaged six to ten percent of total operating costs, that compliance costs increased from $144,000 to $222,000 between 2004 to 2005, and that 2006 compliance costs were forecasted at nearly $248,000. *See* Investment Adviser Association, COST OF COMPLIANCE SURVEY (Nov. 2005) (available at http://www.investmentadviser.org/public/iaacostofcompliancesurvey-2005.pdf) at 8-9.

would have to spend time adjusting the manual to correspond to its organizational structure. The ICAA had earlier estimated that an adviser could enlist the assistance of a third-party compliance firm to draft a firm-specific manual for a small to mid-size firm for between $2,500 and $3,500. The ICAA had also estimated that a law firm would charge between $10,000 and $120,000 to draft procedures (and an accounting firm would charge between $50,000 and $200,000), depending on the size and complexity of the adviser's operations. In light of those findings,[13] we are particularly concerned that the burdens of the Proposed Rules (whatever they may turn out to be) may not have been clearly considered and appropriately balanced in light of the benefits being sought by the Commissioner and the likelihood those benefits will be achieved.

It should also be noted that the Proposed Rules are likely to result in an increase in the demands on the Commissioner's resources. For example, it is likely that examiners at the Department of Corporations will need meaningful training (including, possibly, training in the federal requirements to the extent those requirements are determined by the Commissioner to inform the rules adopted) and more time and resources to conduct their examinations properly. Further, without an increase in resources at the Department to properly administer the Proposed Rules, it is likely that the current services of the Department to California-regulated investment advisers could be substantially diluted.

In light of the foregoing, we recommend the Proposed Rules not be adopted until the Commissioner gives careful consideration to the types of businesses currently conducted by California-licensed advisers, the applicability of specific compliance requirements to the particular benefits sought, the particular risks associated with the types of businesses being conducted by advisers subject to the Proposed Rules, and the costs that such requirements would be likely to entail.

2. **By incorporating standards published by the SEC (or in some cases by SEC Staff) in interpretive letters and releases, no-action letters, and speeches by SEC officials, the Proposed Rules create new disparities between state and federal regulation and the possibility for greater disparities in the future.**

The Proposed Rules with respect to performance-based advertising and "soft dollar" practices would establish regulatory regimes partially derived from selected interpretive and no-action guidance of the SEC and its Staff. As practitioners, we are deeply concerned about this approach. These sources reflect the SEC's or, in some cases, its Staff's, current views, often on specific, limited circumstances. These interpretive positions can be found in SEC interpretive releases, no-action letters and public speeches by SEC officials.[14] Often a particular interpretive

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[13] Letter dated April 17, 2003 from the ICAA on the SEC's "Proposed Rule: Compliance Programs of Investment Companies and Investment Advisers" (SEC Release Nos. IC-25925, IA-2107, File No. S7-03-03; February 5, 2003), available at http://www.sec.gov/rules/proposed/s70303/icaa041703.htm (2 paragraphs immediately following footnote 23 thereof).

[14] Regarding performance-based advertising, see Clover Capital Mgmt., Inc., SEC No-Action Letter (Oct. 28, 1986); Investment Company Institute, SEC No-Action Letter (Sep. 23, 1988); Investment Company Institute, SEC No-Action Letter (Aug. 24, 1987); Wentworth, Hauser & Violich., SEC No-Action Letter (Jul. 19, 1991); In re Robert

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statement or no action letter is only part of a mosaic of positions in a broad area. These types of pronouncements are not substantive regulations binding on investment advisers generally; they do not have the force of law, and are not enforceable by courts. Moreover, as interpretive positions, they are continuously evolving and developing in response to changes in industry and law.

We believe that regulating by reference to no-action and interpretive statements ultimately prevents the Commissioner from effectively harmonizing the California regulatory regime with the federal and other frameworks. Among other things, given the complex nature of the California regulatory process, the Commissioner may find the Department enforcing obsolete rules and incapable of timely amending them and re-harmonizing them efficiently with newer or more widely adopted standards. In the current proposal, references to only portions of the SEC's and its Staff's interpretive positions create inconsistencies with the current application of federal standards. Also, if adopted, the Proposed Rules and in particular Proposed Sections 260.235 and 260.238.2 risk becoming out-of-date or inconsistent with changing SEC views and the federal regulatory regime.

Regarding each of Proposed Sections 260.235 and 260.238.2, the following particulars also should be considered:

a. **Proposed Section 260.235 regarding Performance-Based Advertising.**

Proposed Rule 260.235 amends existing rules by incorporating the principles governing performance-based advertising expressed in a 1986 SEC letter to Clover Capital Management (the "Clover Capital Letter").[15]

In that letter, the Staff of the SEC's Division of Investment Management responded to a no-action request from an investment adviser, Clover Capital Management Inc., that had been advised by the SEC's examination staff that its use of model performance results violated the broad antifraud provisions of Rule 206(4)-1(a)(5)[16] adopted under the Investment Advisers Act of

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T. Littell, *et al.*, Release No. IA-2203 (Dec. 15, 2003); In re Engebretson Capital Mgmt., Inc., *et al.*, Release No. IA-1825 (Sep. 13, 1999); In re LBS Capital Mgmt., Inc., Release No. IA-1644 (Jul. 18, 1997); Lori Richards, Director, Office of Compliance Inspections and Examinations, U.S. Sec. & Exch. Comm'n, "Remarks at the Investment Adviser Compliance Summit" (May 1, 2000). Regarding "soft dollars," *see* Release No. 34-5416 (Jul. 18, 2006); Release No. 34-45194 (Dec. 27, 2001); R.B.G., Inc., SEC No-Action Letter (Nov. 27 1984); Boston Inst'l Serv., Inc., SEC No-Action Letter, (Jul. 20, 1977); Johnson, Lane, Space Smith & Co., SEC No-Action Letter (Jul. 20, 1977); SEC Office of Compliance Inspections and Examinations, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (Sep. 22, 1998); Annette L. Nazareth, Commissioner U.S. Sec. & Exch. Comm'n, "Remarks at the Workshop on Trading Practices and Best Execution" hosted by the Mutual Fund Directors Forum (Jun. 7, 2006).

[15] *See* Clover Capital Management Inc., SEC No-Action Letter (Oct. 28, 1986).

[16] The text of Rule 206(4)-1(a)(5) reads as follows: "(a) It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the [Advisers] Act for any investment adviser registered or required to be registered under section 203 of the Act, directly or indirectly, to publish,
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1940 (the "Advisers Act").[17] The Staff took the request as an opportunity to express its views regarding certain advertising practices that it considered "inappropriate under Rule 206(4)-1(a)(5)."[18] The Clover Capital Letter reversed the prevailing Staff position that the use of model results was per se misleading. It went on to list certain practices that, "in the staff's view," Rule 206(4)-1(a)(5) prohibited, including, among other things, presentation of results that do not reflect the deduction of advisory fees and all other expenses that a client would have paid or actually paid.

Subsequently, the Staff has issued additional performance-based advertising letters, in some cases concluding that some of the practices described in the Clover Capital Letter as misleading, deceptive or fraudulent were not necessarily misleading, deceptive or fraudulent. For example, in 1987, the SEC Staff stated that, notwithstanding the blanket statement in the Clover Capital Letter regarding deduction of *all* fees and expenses the accounts whose performance was reflected in an advertisement, it would not be inappropriate to omit the impact of custodial fees on advertised performance. [19] In 1988, the Staff further provided that an investment adviser could, notwithstanding the Clover Capital Letter, show performance advertising on a gross basis in one-on-one presentations, provided certain conditions were met.[20] Neither of those positions is reflected in Proposed Section 260.235. In these respects (and likely others), proposed Section 260.235 is already inconsistent with federal principles relating to performance-based advertising.

As noted above, the Clover Capital Letter and other interpretive and no-action letters regarding performance advertising represent only the view of the SEC Staff. They are not law or rule[21] and do not represent the official view of the SEC.[22] Most importantly, they do not establish as a matter of law or regulation that advertisements not conforming to the principles articulated by them are necessarily untrue, false or misleading in violation of Rule 206(4)-1(a)(5). The SEC did not, when the Clover Capital Letter was first made available, nor has it since, adopted a rule prohibiting the specific acts listed in the Clover Capital Letter. Rather, in the SEC's view,

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circulate, or distribute any advertisement: . . . (5) which contains any untrue statement of a material fact, or which is otherwise false or misleading."

[17] 15 U.S. C. §§ 80b-1 *et seq.*

[18] At times, as in the Clover Capital Letter, the Staff expresses its views more broadly, describing its analysis and views regarding the interpretation of particular rules and statutes. But these views are not binding on the SEC or on any courts. Moreover, the SEC's no-action and interpretive letters do not constitute substantive regulations or acts of the SEC itself. The Staff of the SEC's divisions respond to specific inquiries with so-called "no action" letters affirmatively expressing (or refusing to express) forbearance from seeking enforcement under applicable regulations.

[19] *See* Investment Company Institute, SEC No-Action Letter (Aug. 24, 1987).

[20] *See* Investment Company Institute, SEC No-Action Letter (Sep. 23, 1988).

[21] *See* In re Sealed Cases, 223 F.3d 775, 780 (D.C. Cir. 2000) (*citing* Christenson v. Harris County, 529 U.S. 576 (2000)).

[22] *See* Informal and Other Procedures, 17 C.F.R. 202.1(d) (2007).

whether particular presentations of performance results are fraudulent, deceptive or misleading depends on all the facts, including the context and the sophistication of the recipients.[23]

If adopted, the Proposed Rules would flatly prohibit practices the SEC Staff now clearly considers permissible. As such, the proposed amendments to Section 235 would not "increase uniformity with investment adviser regulation at the federal level by incorporating the established principles set forth in Clover . . . ."[24] Rather, they would implement a regulatory approach to performance advertising at the state level that is incomplete and is inconsistent with the SEC's current approach.

The Committee believes that existing California laws and regulations provide adequate coverage of the issues the SEC Staff addressed in the Clover Capital Letter and subsequent no action letters. Section 260.235(a)(5) is analogous to Advisers Act Rule 206(4)-1(a)(5) and broadly prohibits any advertisement containing "any untrue statement of a material fact, or which is otherwise false or misleading."

b. Proposed Section 260.238.2 Regarding "Soft Dollar" Practices.

Under the Proposed Rules, Proposed Section 260.238.2 would incorporate Section 28(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), together with certain definitions that paraphrase and summarize some of the interpretive guidance recently issued by the SEC in the so-called "soft dollar" release (the "2006 Release"), which defines the scope of the "research services" an investment adviser may obtain with soft dollars without being deemed to have breached its fiduciary duty.[25] Section 28(e) provides a safe harbor for investment advisers from federal and state claims that commissions paid by clients that are reasonable in relation to the services provided will not evidence a breach of fiduciary duty solely because the amounts exceed those charged by others. This safe harbor is unavailable to the extent an applicable state or federal law expressly provides to the contrary.[26]

The Committee has two concerns regarding the Proposed Section 260.238.2. First, we are concerned that the Proposed Section 260.238.2, at best, duplicates at the state level a safe harbor already provided for by federal law. Second, given the interpretive nature of the 2006 Release and the SEC's history on the "soft dollar" question, the effort reflected in Proposed Section 260.238.2 to harmonize with federal regulation may have been expended for naught as the SEC continues to refine interpretations on this point.

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[23] *See* Munder Capital Mgmt., SEC No-Action Letter, 1996 WL 282742 (May 17, 1996); Triad Asset Mgmt., SEC No-Action Letter, 1993 WL 199088 (Apr. 22, 1993); Clover Capital Mgmt., Inc., SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 78,378 (Oct. 28, 1986).

[24] Statement of Reasons, Document 27/03 C at 2.

[25] *See* SEC Release No. 34-54165 (Jul. 18, 2006).

[26] The pertinent text of Section 28(e) reads as follows:

> [N]o person . . . in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully . . . unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Act Amendments of 1975 . . . .

Based on the text of Section 28(e), in the absence of a California statute specifically overriding the federal safe harbor as to particular "soft dollar" activities (and as to which the Commissioner has statutory authority to provide exemptive relief), Proposed Section 260.238.2 appears to have little legal effect. Section 28(e) already provides the "safe harbor" relief that the Proposed Rule purports to provide.

Further, the benefit of Proposed Section 260.238.2 is unclear in part because it purports to operate as a safe harbor independent of that already provided for under Section 28(e). In other words, Proposed Section 260.238.2 purports to protect advisers from claims of illegality or breach of fiduciary duty so long as the standards under that proposed section are met, including the definitions of "brokerage" and "research". But the coverage of the proposed section is narrower than the safe harbor under Section 28(e).[27] Also, Proposed Section 260.238.2 does not purport to prohibit, protect or otherwise address investment adviser conduct falling outside the statutory safe harbor of Section 28(e) as currently in effect under the Exchange Act. Thus, if a court were called to adjudicate a dispute over an investment adviser's use of "soft dollars", the investment adviser's conduct would be assessed by the terms of Section 28(e) (irrespective of whether that determination was based on the 2006 Release, subsequent SEC guidance or some other source). The Proposed Section would have had no bearing on the outcome of the dispute.[28]

To the Committee's second concern, we believe that distilling the SEC's interpretations of Section 28(e) down to a concise format (often required of regulations) will almost inevitably result in future inconsistencies with Section 28(e) and possibly even immediate inconsistencies upon adoption. The 2006 Release provides an interpretive framework for evaluating and applying the terms of Section 28(e) and represents the latest in the SEC's interpretative work, accumulated over a 20-year period, regarding Section 28(e).[29] In some cases, the 2006 Release reverses earlier views on Section 28(e) and does so based on recent developments in the securities markets. While it includes the standards considered appropriate by the SEC for applying Section 28(e) to particular facts, the 2006 Release is also a nuanced, 62-page discussion that provides "interpretive guidance" on a statute with broad application to all types of persons

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[27] The 2006 Release applies a variety of complex principles which would be difficult to condense in the form of a regulation. By necessity, Proposed Section 260.238.2 includes only the basic components of the 2006 Release. Other elements of the 2006 Release are disregarded entirely. For example, the 2006 Release clarifies that "providing" research includes conduct beyond the plain meaning of "provide", suggesting the delivery of research. Under the 2006 Release, "providing" research includes one of three adviser activities: (i) preparation of research, (ii) assuming the financial obligation to pay for research, or (iii) entering into other, non-financial arrangements (specified under the release) for the provision of research. *See* text of 2006 Release at note 15. Also, by way of example, the 2006 Release extended the application of the "lawful and appropriate assistance standard" to brokerage services. *See* text of 2006 Release at note 82.

[28] Even if this proposed rule did purport to declare illegal (*e.g.*, fraudulent, manipulative or deceptive) uses of soft dollars that are not covered by the rule's protective provisions, it would appear to be rendered ineffective as to activities found to be covered by Section 28(e).

[29] The SEC has provided, and revised, its views on a number of occasions in the past, most recently in 2001, when it reversed a previous interpretive position and softened its interpretation of the term "commission" for brokerage services to include fully-disclosed fees paid in connection with riskless principal transactions. *See* Exchange Act Release No. 45194 (Dec. 27, 2001), 67 FR 6,7 (Jan. 2, 2002).

and entities that exercise investment discretion (including some that are not subject to SEC jurisdiction). While the SEC expressed its current views in the 2006 Release, it specifically stated that it "will receive and consider additional comment ... with respect to client commission arrangements given evolving developments in the industry."[30] Thus, unlike what it does when it adopts a rule, the SEC acknowledged that its views on the coverage and interpretation of Section 28(e) remain a work in progress.

Further, while the 2006 Release has a very significant impact on the behavior of all entities that exercise investment discretion, it does not have the force of law.[31] Thus, as with the concerns raised by Proposed Section 260.235 (described above), the Committee is concerned with the effect of embodying, as binding rules, complex interpretations that should be – and that the SEC has concluded should be – expressed and discussed in a more flexible form. Again, the 2006 Release summarizes considerable analysis and study and offers only interpretive guidance in a complex and rapidly changing area. Because the SEC views the guidance in the 2006 Release as subject to change over time, new Section 260.238.2 will very likely become outdated and incongruous with federal law, perhaps sooner than expected.

Inconsistencies between federal and state regulation will grow with the passage of time and further changes in investment advisers' business practices. Not only does the SEC Staff have the flexibility to refine and even reverse its no-action letter positions relatively easily, its examination and enforcement arms are able to temper strict adherence to the Clover Capital Letter principles or the 2006 Release, as amended and updated through the ensuing years, with the realistic recognition that there are many circumstances in which a failure to strictly adhere to those principles will not involve fraud, deception or manipulation.

3. **By restating federal statutes and rules verbatim, the Proposed Rules risk creating additional disparities with the federal regulatory system. We recommend that, where conformity with federal or model rules is appropriate, rulemaking in this area explicitly cite directly or**

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[30] *See* 2006 Release.

[31] In *Chrysler Corp. v. Brown*, 441 U.S. 281 (1979), its seminal case on the matter, the United States Supreme Court held the following with respect to interpretive guidance issued by administrative agencies:

> In order for a regulation to have the "force and effect of law," it must have certain substantive characteristics and be the product of certain procedural requisites. The central distinction among agency regulations found in the APA is that between "substantive rules" on the one hand and "interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice" on the other. . . . That an agency regulation is "substantive," however, does not by itself give it the "force and effect of law." The legislative power of the United States is vested in the Congress, and the exercise of quasi-legislative authority by governmental departments and agencies must be rooted in a grant of such power by the Congress and subject to limitations which that body imposes. As this Court noted [previously]: "Legislative, or substantive, regulations are issued by an agency pursuant to statutory authority and . . . implement the statute, as, for example, the proxy rules issued by the Securities and Exchange Commission . . . . Such rules have the force and effect of law."

Id. at 302-303 (*internal citations and quotations omitted*).

incorporate by reference the federal or model rule and any successor provision thereto.

We believe that the Proposed Rules would provide a more effective regulatory scheme if they avoided verbatim recitations of Advisers Act provisions. The Commissioner is taking a risk in assuming that federal statutes and SEC regulations will not be changed in the future by taking the approach of restating or paraphrasing verbatim the current text of those statutes and regulations into the regulations adopted under the California securities laws. We recommend that, if the Commissioner adopts rules that follow the principles of federal law, it should take a referenced-based approach and cite directly to those federal laws and their successors in order to avoid unnecessary confusion and expense when the federal law is changed.

As indicated earlier, as a general matter we do not disagree with the objective of harmonizing state regulations with other schemes, where appropriate, and we agree with the Commissioner that California's rules in many areas should not differ greatly from those under the Advisers Act. For example, we suggest that the custody rules under Section 260.237 be amended to coincide with the corollary rules under the Advisers Act. These rules have been inconsistent since 2003. As a result, California-registered investment advisers have been subject to rules and Commissioner positions that are inconsistent with the SEC's rules, even to the point of relying on SEC no-action letters that have been withdrawn by the SEC (e.g., the PIMS, Inc. and Bennett No-Action Letters[32]). The recordkeeping rules in Section 260.241.3 have also differed from Advisers Act rules since 2001. Further, there is a significant risk that, if the Commissioner adopts amendments to Section 260.241.3, as proposed, the new rule will again diverge from those under the Advisers Act. In this connection, we note that Andrew Donohue, the Chairman of the SEC's Division of Investment Management, stated last month that the SEC is taking a "fresh look" at its recordkeeping rules.[33]

The performance fee rules provide an example of Commissioner rulemaking that took an approach similar to the approach the Committee suggests. Section 260.234 (compensation based on capital gains) mirrored the language of Advisers Act Rule 205-3 until 1998 when the SEC simplified and broadened that rule. The corresponding California rule was not harmonized with Rule 205-3 until 2001,[34] following a three-year period of uncertainty and inconsistency. However, when California's rule was amended to conform to the federal rule, the Commissioner wisely provided that performance-based compensation would be acceptable if it complied with certain of the conditions imposed by Rule 205-3, simply referencing the federal rule instead of

[32] *See* PIMS, Inc., SEC No-Action Letter (Oct. 21, 1991) and Bennett Management Co. Inc., SEC No-Action Letter (Feb. 26, 1990) *subsequently withdrawn by* Release No. IA-2176, "Custody of Funds or Securities of Clients by Investment Advisers" (Sep. 25, 2003).

[33] Andrew J. Donohue, Remarks Before the Investment Company Institute 2007 Operations and Technology Conference, October 18, 2007. Available at http://www.sec.gov/news/speech/2007/spch101807ajd.htm).

[34] *See* 2001 CAL. REG. L.B. 33 ("Regulations pertaining to an investment adviser's compensation based on capital appreciation of clients' assets have been amended to conform to recent changes adopted by the Securities and Exchange Commissioner.").

rearticulating its substance. The Committee believes that a similar approach, perhaps facilitating amendment of substantive rules, is appropriate in most cases.

We recommend that the Commissioner take a more systemic and long-term approach to preserving consistency, where doing so would be appropriate, through the "reference-based" approach to selected rules described above. Regulations, such as proposed Section 260.237 (governing custody-related requirements), certain proposed amendments to Section 260.238 (requiring policies and procedures for insider trading), Section 260.238.2 (governing payments for client solicitations), Section 260.238.1 (requiring codes of ethics), and Section 260.241.3 (relating to recordkeeping), are based on analogous SEC rules and may be good candidates for this approach.[35] We recognize that the approach taken in the Proposed Rules, verbatim restatement of other rules, is consistent with that taken in the Model Rules. Nonetheless, given the complex nature of California's regulatory process and to avoid lengthy periods of disparity and disharmony among regulatory regimes, in areas where the Commissioner has not deliberately concluded there is an important reason for different regulation at the state level, we believe the Commissioner should reconsider that verbatim restatement approach. We submit that the reference approach, which would permit more complete and, possibly real-time adaptation, is an alternative that should be considered in appropriate cases.

B. If the Commissioner does not accept our recommendation described in A above, we would then recommend that the period for the submission of written comments be extended by ninety days to January 28, 2008. Given the complexity of the Proposed Rules and the concurrent development of standards and practices on the federal level (and within the investment management industry generally), the comment period should be extended to allow the members of the bar and members of the investment community to better understand and assess the legal and practical issues raised by the Proposed Rules.

As noted at the beginning of this letter, the Committee greatly appreciates and strongly supports the Commissioner's efforts to harmonize California's investment advisory regime with the federal regime. We recognize the complexity and difficulty of doing so in the broader context of the rapid growth and evolution of the investment advisory business sectors and the increasingly different types of advisers regulated on the state and federal level. In light of our comments in Part A of this letter, we recommend the Commissioner extend the written comment period for the Proposed Rules by at least 90 days until January 28, 2008. This would provide greater notice to the investment advisory committee as well as a greater opportunity for interested parties to provide specific input to the Commissioner with respect to the Proposed Rules. In addition, a longer comment period would allow the Commissioner to assess the costs and benefits, as well as the appropriateness, of each rule, perhaps in a more interactive format or by working directly with various constituencies to develop a more effective regulatory regime.

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[35] We recognize that Proposed Section 260.238.1 distinguishes between "small advisers" from other advisors. *See* Proposed Section 260.238.1(d). We support this distinction and would recommend that any "reference-based" approach applied to this proposed section should maintain that distinction.

C. If the Commissioner does not accept our recommendation summarized in A above and also does not accept our recommendation summarized in B above, we would then recommend that the Proposed Rules be made effective no earlier than January 1, 2009 or at least one year from the date of adoption (whichever is later). We believe the additional time is necessary and appropriate in light of the significance of the burden imposed by the Proposed Rules.

To comply in a meaningful way with the Proposed Rules, California-licensed investment advisers will need to develop and adopt additional written compliance procedures, recordkeeping, and disaster recovery systems, and to train personnel to implement those new procedures. These steps will require significant time, money, and attention from investment of advisers if they are to be undertaken thoughtfully and accurately. It is not in the public interest to set timetables for compliance that may result in advisers taking shortcuts or adopting generic or boilerplate policies and procedures.

The SEC's major expansion of formalized compliance rules under the Advisers Act and other rules affecting investment advisers has increased the demand for consulting services from outside lawyers and other compliance professionals experienced in this industry. Because of the scope of the compliance policies and procedures now required, many registered advisers (who previously sought only minimal periodic consultations with outside lawyers or other consultants to meet their routine compliance needs) will now require additional services and outside expertise and may need the help of full-time in-house compliance experts or make historically unprecedented demands on outside compliance professionals. As a result, the market for experienced compliance personnel has become much more competitive and their availability much more scarce. Compensation has increased dramatically as advisers bid to retain this scarce resource. The Proposed Rules will intensify the already stiff competition for such compliance professionals.

If the Proposed Rules are adopted, we are concerned that a short compliance period would be unrealistic. It would promote a scramble to reach compliance in the formal sense alone, but may not promote the an appropriate "tone" or sensitivity to genuine compliance among California investment advisors that the Commissioner appears to be seeking. As stated above, we believe the Proposed Rules (other than the custody rules) should not be adopted. However, if they are adopted, we recommend that they be made effective no earlier than January 1, 2009 or, if later, at least one year after the Proposed Rules are adopted.

D. We recommend the adoption of Proposed Section 260.237, subject to certain modifications.

We recommend that the Commissioner adopt Proposed Section 260.237, subject to our comments provided in Part A3 of this letter (above). However, we recommend that the Commissioner remove the minimum current ratio requirement from the Proposed Rules.

There is no minimum current ratio requirement contained in either the federal rules or in the Model Rules.[36] Thus, including this requirement is incongruous with the stated goal of increasing uniformity with investment adviser regulation in other states and with the federal rules.

Alternatively, if the Commissioner retains the minimum current ratio requirement, we recommend that the pertinent provision be revised to require a fixed minimum current ratio requirement rather than a "positive current ratio". Ordinarily, a "current ratio" is understood to mean the ratio of current assets to current liabilities appearing on a company's balance sheet. Technically, an investment adviser could fail to have a *positive* current ratio only if it had either negative current assets or negative current liabilities. On the other hand, an investment adviser with *minimal* current assets (e.g., $10 in cash) and extraordinary current liabilities (e.g., $50,000,000 in credit line borrowings) could satisfy the Commissioner's requirement with a very low, but positive current ratio (e.g., 0.0000002:1.00 in the example). Therefore, a rule requiring a fixed *minimum* current ratio requirement would be a more meaningful measure of an investment adviser's financial well-being.

E. The Commissioner appears not to have statutory authority to adopt certain of the Proposed Rules. We recommend that the Commissioner appropriately modify those Proposed Rules to fall within the scope of authority granted to the Commissioner by the legislature.

At the present time, we are unable to provide in writing a complete analysis of the effect of the California Administrative Procedures Act (and the rules promulgated thereunder) on the legality and enforceability of the Proposed Rules. In other sections of this letter, we drew your attention to specific procedural requirements of that act governing the rulemaking process and, in particular, the need for appropriate justification to support a rulemaking proposal. We are also concerned with the Commissioner's authority to adopt certain of the Proposed Rules. Several of those rules apply both to licensed investment advisers and to those required to be licensed, for example. That would be consistent with the scope of some provisions of California securities laws but would exceed the statutory authority upon which some of the Proposed Rules are based.[37] Specifically, we note that Proposed Rule 260.237.3 imposing net worth requirements on every investment adviser exceeds the statutory authority of the Commissioner as specified in the California securities laws. The same also appears to be true with respect to Proposed Sections 260.238.1, 260.238.2, 260.238.3 and 260.238.4. Prior to adoption, each of the Proposed Rules will need to be reviewed to confirm that they do not regulate matters beyond the statutory authority of the Commissioner. Any such rules exceeding the Commissioner's authority would, obviously, need to be revised accordingly.

As this letter may not be the appropriate medium to raise these issues, we invite the Commissioner (and his Staff) to speak with us directly regarding this concern.

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[36] *Compare* proposed CAL. CODE REGS. tit. 10, §260.237(2)(c) *with* NASAA MODEL RULE §202(d)-(1) (2004).

[37] *Compare* CAL. CORP. CODE § 25235 *with* §§ 25237 and 25258.

F. Apparent Errors.

The Proposed Rules appear to have the following technical errors:

1. Proposed Section 260.231.

The reference, included in Proposed Section 260.231(a)(1), to ADV Part II is mislabeled in existing Rule 260.231(a)(1) as "Part 2." Since that provision would be***[NB: missing word***?] if Proposed Section 260.231 were adopted, it should be corrected to reference "Part II."

2. Proposed Section 260.235.

By its terms, Section 260.235(a) applies to all investment advisers, not just those licensed in California. That is consistent with the scope of Corporations Code § 25235 on which authority it is based. The exception proposed to be added with Section 260.235(a)(2) incorporates the provisions of Proposed Section 260.235(b), which is applicable by its terms *only* to investment advisers licensed in California. That is potentially misleading and certainly is confusing and thus we assume that may be only an oversight in drafting. We also note that the corresponding advertisement Rule 206(4)-1 adopted under the Advisers Act applies only to investment advisers that are registered (or required to be registered) under the Advisers Act. As one of the purposes of the Proposed Rules is to harmonize California and federal regulations, this would be an appropriate opportunity to modify Section 260.235(a) to conform to the approach under the Advisers Act.

3. Proposed Section 260.237(a)(7).

The second half of this section ought to be revised from " . . . who does not meet the exception provided under paragraph (b)(3) of this section . . . " to " . . . who does not meet the exception provided under *paragraph (b)(2)* of this section . . . ."

One express purpose of amending Proposed Section 260.237 is to incorporate changes under the NASAA model rules (there is no federal rule analogous to proposed Section 260.237(a)(7)). The analogous section of the model rules states that an investment adviser with custody over pooled investments need not comply with independent representative disbursement procedures if it is subject to an annual GAAP audit.[38] The model rules accomplish this by cross-referencing "the exception provided under paragraph 102(e)(1)-1(b)(3)," which is an exception granted to a general partner if it is subject to annual GAAP audits.

Proposed Section 260.237(a)(7) mimics this language by cross-referencing "paragraph (b)(3) . . . "[39] However, because California is not adopting all portions of the model rules, the paragraph containing the GAAP audit exception is paragraph (b)(2) and not paragraph (b)(3).[40]

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[38] *See* NASAA MODEL RULE §102(e)(1)-1(a)(7) (2005).

[39] *See* proposed CAL. CODE REGS. tit. 10, §260.237(a)(7) (2007).

4. Proposed Section 260.237(b)(2).

The first sentence of this section ought to be revised from: "The investment adviser is not required to comply with subsection (a)(3) of this rule . . ." to "The investment adviser is not required to comply with *subsection (a)(4)* of this rule . . ."

Proposed Section 260.237(b)(2) and the analogous section of the NASAA model rules conflict with the analogous section of the federal rules.[41] That section of the federal rules states that a limited partnership subject to an annual GAAP audit need not send quarterly account statements to clients. The federal rule accomplishes this by cross-referencing "paragraph (a)(3) of this section."[42] Paragraph (a)(3) describes the quarterly account statement requirement.[43]

Proposed Section 260.237(b)(2) and the analogous section of the model rules seemingly attempt to achieve the same result by making the same cross-reference to "subsection/[paragraph] (a)(3)."[44] However, both the proposed California rules and the model rules have inserted a subsection/paragraph "(a)(1)" that has no counterpart in the federal rules.[45] As a result, the subsections that are analogous to the federal rules' "(a)(3)" are each numbered "(a)(4)".[46]

5. Mislabeling of Proposed Section 260.238.1(e).

Within this section, there are two consecutive subsections that are both numbered §260.238.1(e). The first contains certain definitions. The second contains some exculpatory language. The second should be renumbered § 260.238.1(f).

6. Exception for Section 260.241.3.

Section 222(b) of the Advisers Act prohibits States from enforcing laws or regulations applicable to investment advisers licensed in more than one State that would require maintenance of books and records in addition to those required under the laws of the State in which the investment adviser maintains its principal place of business if the investment adviser meets certain qualifications specified in that Section. By its terms, Proposed Section 260.241.3 could

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(..continued)

[40] *Compare* proposed CAL. CODE REGS. tit. 10, §260.237(b)(2) (provides GAAP audit exception) *with* proposed CAL. CODE REGS. tit. 10, §260.237(b)(3) (provides exception for investment advisers to registered investment companies).

[41] *Compare* proposed CAL. CODE REGS. tit. 10, §260.237(b)(2) and NASAA MODEL RULE §102(e)(1)-1(b)(3) *with* 17 C.F.R. §275.206(4)-2(b)(3) (2005).

[42] *See* 17 C.F.R. §275.206(4)-2(b)(3).

[43] *See* 17 C.F.R. §275.206(4)-2(a)(3).

[44] *See* proposed CAL. CODE REGS. tit. 10, §260.237(b)(2) and NASAA MODEL RULE §102(e)(1)-1(b)(3).

[45] *See* proposed CAL. CODE REGS. tit. 10, §260.237(a)(1) ("Notice to the Commissioner") and NASAA MODEL RULE §102(e)(1)-1(a)(1) ("Notice to the Administrator").

[46] *Compare* proposed CAL. CODE REGS. tit. 10, §260.237(a)(3)-(4) *and* NASAA MODEL RULE §102(e)(1)-1(a)(3)-(4) *with* 17 C.F.R. §275.206(4)-2(a)(3).

apply in situations contravening that provision of the Advisers Act. This Proposed Section therefore needs an exception covering the situations specified in the Advisers Act.

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We applaud the Commissioner for the significant effort it has undertaken in preparing the Proposed Rules and will make our members available for in person conversation regarding the foregoing comments to the extent helpful during the Commissioner's consideration of the Proposed Rules.

Please note that the positions set forth in this letter are only those of the Corporations Committee. As such, they have not been adopted by the Business Law Section or its overall membership, or by the State Bar's Board of Governors or its overall membership, and are not to be construed as representing the position of the State Bar of California. Membership on the Corporations Committee and in the Business Law Section is voluntary, and funding for their activities, including all legislative activities, is obtained entirely from voluntary sources.

Please do not hesitate to contact either of the undersigned if you have any questions or concerns about the matters raised in this letter.

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